Pension benchmarks give consumers false impression of fund performance

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Research suggests savers may not be getting a true picture of the performance of their pension fund. Credit: University of Bath

Benchmarks that measure the performance of pension funds, and fees charged to consumers by investment fund managers, require greater scrutiny, suggests new research from the University of Bath.

Personal pension funds on average beat their benchmarks but the study shows this owes less to the investment skill of pension managers and more to the selection of benchmarks which are easy to outperform.

The research on over 4,500 personal pension funds operating in the UK, Jumping over a low hurdle: Personal pension fund performance, led by Ania Zalewska, Professor of Finance at the University's School of Management and Founding Director of the Centre for Governance and Regulation, is published in the *Review of Quantitative Finance and Accounting*.

The research also suggests that the use of wider classes of assets to generate good returns could be better exploited. A simple passive strategy of investing 80 per cent in the FTSE benchmark and 20 per cent in one of several emerging markets equity indexes would on average allow funds specialising in UK equity to outperform their benchmark by three to four per cent, about two per cent above their observed outperformance.

When a new pension fund is created, a Primary Prospectus Benchmark (PPB) is chosen and used as a comparator when assessing the fund's performance. However, the investment behaviour of the fund is allowed to be broader than would appear from its official description of investment style and chosen benchmark. So using the prospectus benchmark to assess the success of the fund can give a false impression of the fund's performance.

For example, a fund classified as UK equity is in fact allowed to invest up to 20 per cent of its assets under management in assets other than UK equity. However, if the benchmark against which the fund has chosen to be judged is 100 per cent UK equity focused (eg FTSE All Share Index) someone investing purely in the benchmark has less opportunity to make money in risk adjusted terms than the fund investing in a broader asset class.

Professor Zalewska said: "This study provides convincing evidence that pension funds are reporting their performance in relation to benchmarks which are not reflective of their true investment profile. It creates a spurious impression of good investment skills for consumers who are paying a premium for actively managed funds.

"In the climate of regulatory and government concerns about old-age provision, and mass replacement of Defined Benefit pension schemes by Defined Contribution schemes that shift the consequences of poor performance of funds onto contributors, this research is of particular relevance."

The research investigates a wide range of investment styles (fixed income, domestic equity, overseas equity, allocation funds that offer a mix of equity and fixed income assets) from 1980 to 2009. It discusses differences between performance measured on annual basis and over the whole funds' operational life.

It shows that funds specialising in emerging markets equities are, on average, most profitable, followed by funds specialising in international equities. The performance of the most common investment styles (allocation, fixed income and domestic, ie UK, equity) is less impressive.

Professor Zalewska said: "The results are consistent with the diversification argument, however, it does not offer an ultimate solution for pension saving allocation. The risk of overseas funds and, in particular, those specialising in emerging markets, may be much higher than the risk of any other investment styles. This, high risk exposure may not be agreeable with a preferred risk profile of many pension contributors. Moreover, the reported high returns earned by the emerging market indexes and the funds specialising in emerging markets should be treated with caution for long-term investments."

The School of Management was ranked 8th in the UK in the independently-assessed Research Excellence Framework. 89 per cent of their submitted case studies were deemed to have an outstanding or very considerable impact.

More information: link.springer.com/article/10.1 … 07/s11156-015-0546-9

Provided by University of Bath